

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of)	
)	
Review of the Commission's Rules Regarding)	
the Pricing of Unbundled Network Elements)	WC Docket No. 03-173
and the Resale of Service by Incumbent Local)	
Exchange Carriers)	
_____)	

**COMMENTS
OF THE
UNITED STATES TELECOM ASSOCIATION**

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COMMENTS OF THE UNITED STATES TELECOM ASSOCIATION

The United States Telecom Association (USTA),¹ through the undersigned and pursuant to the Public Notice² released by the Federal Communications Commission (FCC or Commission) and pursuant to Sections 1.415 and 1.419 of the Commission's rules, submits its comments in response to Commission's Notice of Proposed Rulemaking (NPRM) in the above-referenced proceeding.

Introduction and Summary

Seven years after adopting the Total Element Long-Run Incremental Cost (TELRIC) methodology, the Commission has undertaken a comprehensive review of its approach for setting unbundled network elements (UNE) rates.³ Application of the TELRIC methodology by

¹ USTA is the Nation's oldest trade organization for the local exchange carrier industry. USTA's carrier members provide a full array of voice, data and video services over wireline and wireless networks.

² Public Notice, WC Docket No. 03-173, DA 03-3278 (rel. Oct. 20, 2003) soliciting comment on the Commission's Notice of Proposed Rulemaking to examine the rules applicable to pricing of unbundled network elements and resold telecommunications services made available by incumbent local exchange carriers to competitive local exchange carriers.

³ *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, WC Docket Number 03-173, FCC 03-224 (rel. Sept. 15, 2003) (NPRM).

regulators across the country has shown that it falls far short of achieving the Commission's goals of producing "just [and] reasonable" rates that "promot[e] sustainable competition" and do "not create incentives for carriers to avoid investment in facilities."⁴ USTA accordingly urges the Commission to take this opportunity to alter some of the basic assumptions of its UNE pricing methodology, and to reform TELRIC so that it is "more firmly rooted in the real-world attributes of the existing network" and more closely compensates incumbent local exchange companies (ILECs) for their real, forward-looking costs.⁵

Discussion

I. The Commission's TELRIC Methodology for UNE Pricing Fails to Meet the Commission's Own Goals for UNE Pricing

The fundamental question at the outset of the NPRM is whether the TELRIC "methodology is working as intended and, in particular, whether it is conducive to efficient facilities investment."⁶ The plain answer is that TELRIC is *not* operating as intended. As countless investment analysts have concluded, TELRIC has deterred new facilities investment by competitors and devalued existing investment for *all* facilities-based carriers including ILECs, large and small, across the country. Analysts at McKinsey & Co. and JP Morgan have described the investment incentive for CLECs under TELRIC as follows: "[n]o company will deploy and scale facilities if it can achieve similar economics immediately by renting network

⁴ NPRM ¶ 3.

⁵ NPRM ¶ 4.

⁶ NPRM ¶ 3.

elements from the ILECs — all with little up-front investment.”⁷ Another analyst testifying before Congress explained that, “the macroeconomic consequences of the FCC’s TELRIC fiat was to devalue three quarters of the Nation’s telecom infrastructure by two-thirds.”⁸ And a recent study by four esteemed economists, three of whom are Nobel prize winners, warns that the potential for economic damage as a result of TELRIC’s distorted investment incentives “could be large and could extend beyond the telecommunications sector.”⁹

This serious disincentive effect is a direct result of what the Commission has acknowledged is “the excessively hypothetical nature of the TELRIC inquiry.”¹⁰ In the Commission’s own words, TELRIC assumes a “scorched node network,”¹¹ in which the least cost, newest technology “will be deployed instantaneously and ubiquitously.”¹² As the Commission recognizes, this fictional exercise provides “state commissions [with] wide latitude in applying the ‘most efficient technology’ standard” and allows TELRIC proceedings to become “a ‘black box’ from which a variety of possible rates may emerge.”¹³ In fact, the lack of any real-world anchor for UNE rates — or the underlying TELRIC assumptions — necessarily

⁷ McKinsey & Co. and JP Morgan H&Q, *Broadband 2001, A Comprehensive Analysis of Demand, Supply, Economics, and Industry Dynamics in the U.S. Broadband Market* at 18 (Apr. 2, 2001).

⁸ *Hearings before the Subcomm. On Telecommunications Trade & Consumer Protection of the House Commerce Comm.*, 106th Cong. 2 (May 25, 2000) (Written statement of Scott Cleland, Managing Director, The Precursor Group).

⁹ Report of Kenneth Arrow, Gary Becker, Dennis Carlton and Robert Solow, On Behalf of Verizon, at 23 (November 18, 2003), *available at* http://lexecon.com/documents/Publications/1/9/5/VZTECH_Report_Nov_18.pdf.

¹⁰ NPRM ¶ 7.

¹¹ NPRM ¶ 17.

¹² *Id.* ¶ 31.

¹³ *Id.*

results in UNE rates that do not come close to approximating the costs that ILECs bear in providing UNEs to CLECs, and that cannot send correct economic signals about when CLECs should invest in their own facilities. To the contrary, the excessively hypothetical assumptions underlying current applications of TELRIC produce UNE rates so low that they create a significant disincentive to investment.

This result is embedded in the current central assumption of TELRIC that prices should be set as though a carrier would instantaneously and ubiquitously — and repeatedly — deploy the most efficient technology currently available. In the real world, *no* carrier — incumbent or new entrant — would or could engage in the pace of technological replacement that TELRIC assumes. Even in the most competitive environment, no carrier would abandon completely its existing facilities in favor of instantaneous and constant redeployment of the most efficient available technology in the most efficient configuration. The telecommunications industry is an industry of high sunk and transaction costs; at the same time, the pace of technological development in the telecommunications industry is rapid and ongoing. Accordingly, it would be cost prohibitive, and entirely irrational, to replace all existing assets with the newest generation of technology each time one is released. This is especially true given that assets in the telecommunications network work in a coordinated fashion: replacing one type of asset with a newer version might produce incompatibility with investment made in another network asset, and thus require revamping *that* part of the network as well. It also makes no sense to make such a major change if the current technology is functioning fine, and the industry anticipates that by skipping a generation or two of interim developments, overall costs and efficiency could be optimized.

TELRIC simply assumes that carriers could ignore such considerations altogether. But no real world carrier *could* engage in such radical disregard for past or anticipated technology choices. Therefore, no carrier could ever achieve the ubiquitous deployment of the most efficient, least cost technology that TELRIC assumes. The Commission acknowledges as much, finding in the NPRM that: “In the real world . . . even in extremely competitive markets, firms do not instantaneously replace all of their facilities with every improvement in technology. Thus, even the most efficient carrier’s network will reflect a mix of new and older technology at any given time.”¹⁴

TELRIC’s scorched node approach makes similarly unrealistic assumptions concerning network routing and facilities, engineering a network that follows the shortest, “perfect” route to serve customers, and that “just fits” existing needs. But no real world carrier could achieve these results, either. In the real world, carriers encounter topographical, geographical, and local regulatory obstacles that dictate achievable routing choices. Achieving “perfect” fit is not even a valid engineering goal: to meet service quality goals and carrier of last resort obligations, and to provide efficient and responsive service, carriers must make predictive judgments about deployments based on sound engineering experience and guidelines. Replacing such real-world experience with the guesses of regulators (or competitors) about how a network *should* be designed inevitably produces unrealistic rates that bear no relation to an operational network.

As the Commission also has recognized, current applications of TELRIC have yet another critical flaw: regulators understate costs still further by failing to account for the

¹⁴ NPRM ¶ 50.

substantial risks associated with such a marketplace.¹⁵ In a perfectly competitive market in which new entrants constantly were deploying the most efficient, least cost technological innovation, the cost of capital would be extremely high, while depreciation lives for existing technology would be exceedingly short. Yet regulators consistently have adopted costs of capital that hardly account even for existing competitive risk, much less the perfect competition assumed by TELRIC. And regulators similarly have insisted on using outdated regulatory lives that cannot possibly account for current and anticipated technology and competition, much less the hypothetical levels assumed under TELRIC.

The effect of all the counterfactual assumptions underlying current applications of TELRIC is that UNE rates across the board have been radically understated and do not allow incumbent LECs to recover their actual forward-looking costs in providing UNEs. A comprehensive study of UNE rates conducted by Commerce Capital Markets found that, “[f]or all RBOCs, UNEs are priced below cash operating cost, and radically below total operating cost including depreciation and amortization. The discounts from total cost are 50%-60% below total cost even when total cost does not include cost of equity”¹⁶

The attached analysis of UNE rates produced by the Commission’s UNE pricing rules, by economists Jeffrey Eisenach and Janusz Mrozek, demonstrates that there is little relationship between the rates produced by the application of TELRIC by the state commissions and the

¹⁵ NPRM ¶¶ 4, 22. *See also Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Report and Order, 18 FCC Rcd 18945, ¶¶ 675-91 (2003).

¹⁶ Anna M. Kovacs, et al., *The Status of 271 and UNE-Platform in the Regional Bells’ Territories* at 15 (May 1, 2002).

actual forward-looking costs of providing UNEs.¹⁷ Relying on data compiled by the National Regulatory Research Institute (NRRI) with respect to real UNE rates, and assessing costs based on the Commission's own universal service model (the Synthesis Model), the study uses regression analysis to assess the UNE rate variation across states. The authors conclude that "the variations in state-set UNE rates *not* explained by variations in cost are substantial."¹⁸ The results of this analysis confirm the Commission's concern that the "variable results" in UNE rates "may not reflect genuine cost differences."¹⁹ And the authors further conclude that, "price deviations of the magnitude reported here can be expected to have real and substantial economic effects."²⁰

This significant deviation between UNE rates and costs discourages investment by both competitive and incumbent LECs in new facilities. To begin with, as the Eisenach and Mrozek study shows, the UNE rate-setting process is entirely unpredictable, which creates an unstable regulatory environment which in itself is a disincentive to investment.²¹ Further, no carrier could possibly duplicate a real operational network at current UNE rates, and thus CLECs will rationally tend to choose the UNE rates over investment in their own facilities. If the ILECs are not able to recover their UNE costs from UNE rates, they too will be disinclined to invest in new

¹⁷ Jeffrey A. Eisenach and Janusz R. Mrozek, *Do UNE Rates Reflect Underlying Costs?* The CapAnalysis Group LLC 2 (Dec. 15, 2003), Attachment A to attached Declaration of Jeffrey A. Eisenach and Janusz R. Mrozek (Attachment A).

¹⁸ Attachment A at 15 (*emphasis added*).

¹⁹ NPRM ¶ 6. Instead, these variations reflect the hypothetical nature of the TELRIC rules, and, as the Commission itself concluded, "the complexity of the issues . . . and uncertainty about how to apply those rules." NPRM ¶ 6.

²⁰ Attachment A at 20.

²¹ See Attachment A at 21.

facilities. And facilities-based competitors of all types, inter and intra-modal, cannot possibly compete against the subsidized rates enjoyed by UNE-based CLECs; their investment, too, is devalued. As noted above, this is precisely what has occurred. TELRIC thus manifestly is *not* serving the Commission's oft-repeated goal of creating incentives for investment in facilities and the development of facilities-based competition.²²

The devaluation of facilities investment, and the underrecovery produced by UNE rates generally, has a disproportionately large effect on smaller and more rural ILECs. While all ILECs bear the brunt of underpriced UNE rates, the differential between the cost of providing UNEs and UNE rates can have a direct impact on financial solvency for smaller ILECs whose business interests are less diversified. Although CLECs to date have concentrated on the most lucrative, high usage customers in urban areas, over time, as CLECs become more established, they are increasingly reaching out to more customers in a broader range of service areas, including those served by smaller and rural ILECs. The negative effects of TELRIC will thus increasingly affect these carriers, and given the high costs of serving rural areas, the magnitude of the effect is likely to be even bigger.

Indeed, smaller ILECs are particularly ill-equipped to bear even the administrative costs associated with the current TELRIC regime. State UNE rate proceedings have become enormously complex and expensive.²³ The hypothetical nature of TELRIC makes it difficult to set meaningful guidelines concerning relevant evidence or to limit endless speculation and argument about potential efficiencies. As a result, UNE proceedings disintegrate into protracted

²² NPRM ¶ 38. *See also Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, ¶ 672 (1996).

²³ *See* NPRM ¶ 6.

and expensive battles between experts and consultants. On top of that, UNE rate cases typically involve massive and burdensome discovery. And these proceedings last months and often years. The process alone, as well as the absence of certainty, is exceptionally burdensome for small incumbents and simply diverts resources that should and could be better spent on improving the network and streamlining services and costs.

For these, as well as many other reasons described at greater length in other comments, the Commission is right to propose comprehensive reform of its TELRIC methodology of UNE pricing. Following the seven-year trial of the TELRIC methodology in the state commissions, the Commission should recognize that the methodology has not resulted in the attainment of the Commission's UNE pricing goals. To achieve the goals — and in particular to encourage the development of facilities-based competition — the Commission should change its UNE pricing methodology.

II. The Commission Should Reform TELRIC So That UNE Costs Are Based on the Incumbent's Actual Forward-Looking Costs in Providing UNEs

The NPRM “tentatively conclude[s]” that UNE prices should be based on “a cost inquiry that is more firmly rooted in the real-world attributes of the existing network, rather than the speculative attributes of a purely hypothetical network.”²⁴ The Commission should firmly embrace that approach and provide regulators with clear guidelines with respect to how it should be implemented.

Basing UNE rates on the ILEC's actual forward-looking UNE costs will send efficient economic signals to both ILECs and CLECs. Basing UNE rates on the actual forward-looking costs of providing UNE facilities and services will send CLECs the proper economic signals

²⁴ NPRM ¶ 4.

about whether to invest in their own facilities or rely on the ILEC's. Since the CLEC's own investment decision will compare the costs of producing a real, operational facility with relying on UNEs, the UNE rate should similarly reflect the costs of real, operational facilities. This requires using real-world data based on the ILEC's existing network, not hypothetical assumptions. The ILECs' real-world costs are efficient. ILEC rates have been subject to price caps at both the federal and state level for many years, which has provided substantial incentive for ILECs to root out inefficiencies and reduce their costs. Increasing inter and intra-modal competition has made efficiency an even more significant mandate: as ILECs lose customers and traffic to wireless providers, cable telephony, and voice-over-IP, and their revenues decrease, it is imperative that they find ways to decrease costs and price their services to attract customers. As a result, the ILECs' real-world costs provide a far more realistic picture of an efficient, forward-looking network than costs based on a fictional network created out of whole cloth by consultants and regulators, and rates based on those network costs are far more likely to send relevant and accurate economic signals.

Basing UNE rates on an incumbent's actual forward-looking UNE costs will result in a more transparent and verifiable rate-setting process. Using real-world data about an operational network is an inherently more transparent and verifiable basis for setting UNE rates than a process that devolves into speculation and hypothesis.²⁵ ILECs' engineering guidelines, contracts, and publicly reported ARMIS data, for example, are an objective, verifiable source of data that should be used to support the assumptions and inputs in cost models, rather than expert opinion about how the network *should* work.

²⁵ See Attachment A at 21 (describing current UNE rates as "scatter-shot").

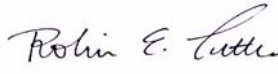
Specific cost recommendations. The Commission must not only articulate general principles, it should provide specific guidance with respect to the key inputs that drive UNE costs. For example, fill factors, structure sharing, technology assumptions, the switch discount have all been manipulated to produce below-cost UNE rates that bear no relationship to reality. The Commission should specify the principles and evidence that states should use to select such inputs. Fills, for example, should reflect the engineering guidelines used by the ILEC and the operational realities of the network, including the need to account for churn and other considerations. Similarly, operating expenses should be determined using the actual out-of-pocket expenses the incumbent will incur. Cost of capital and depreciation should be set to reflect the real-world competitive and technological risk that the ILEC faces, as well as the regulatory risks involved in providing UNEs. This is not intended, of course, to be an exhaustive list. The Commission should consider each of the major cost categories as set forth in its NPRM, and ensure that it has provided concrete direction to guide future UNE cost proceedings.

Conclusion

The Commission should take this opportunity to reform its UNE pricing methodology so that the methodology accomplishes the goals of sending efficient entry and investment signals to all carriers and permits ILECs to recover their actual forward-looking costs of providing UNEs. In order properly to reform TELRIC, the Commission must abandon the hypothetical network assumptions of today's TELRIC and instead ground UNE rates in the ILECs' real-world networks.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Meena Joshi, do certify that on December 16, 2003, the aforementioned Comments of The United States Telecom Association were electronically mailed to the following:

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